

Threadneedle thinks

House views

2012 is likely to prove just as challenging as 2011 for investors. Despite the on-going Eurozone crisis and lacklustre economic outlook in the developed world, opportunities exist across asset classes.

Equities – survival of the fittest

We expect the strong to continue to get stronger in 2012, as proven management teams with robust business models and strong franchises will prosper. Many of these quality companies are inexpensively valued, affording them significant scope to outperform.

Our focus remains on businesses that can grow in a low-growth world. We favour companies selling into emerging markets; businesses with access to a secular theme such as providing healthcare services to ageing populations; or companies with superior products or intellectual property that will help cushion them from the economic cycle. We are also finding good opportunities among companies that are undertaking 'self-help' initiatives – where new management, cost cutting and share buybacks are creating potential value that is not yet reflected in the share price.

Fixed Income – the search for yield

With interest rates set to remain at historically low levels and government bond yields also offering little value, the search for yield is likely to be a major theme in 2012. A number of asset classes could benefit from this.

Corporate, high yield and emerging market bonds continue to offer healthy yields, coupled in many areas by robust fundamentals. Company balance sheets are generally strong following several years of prudent cash management. Emerging market economies are benefiting from superior growth, relatively low debt and high FX reserves. As such, we continue to prefer these areas within fixed income.

Commodities – not all that glitters is gold

Whilst demand drivers remain weak due to concerns over global growth, sectors with tight supply dynamics are likely to see prices pushed higher. The energy sector is one such area, with growing geopolitical risks in the Middle East strengthening our conviction trades in the coming months. Our largest overweight is in refined oil products, where we expect the market to tighten significantly near term.

We are underweight base metals due to the deteriorating macro environment and worsening GDP growth prospects for developed economies. Our underweight position in soft commodities also remains in place, with a further correction likely after recent strong performance.

Multi-Asset – pulling it all together

We remain overweight equities. Company balance sheets are strong, many businesses are returning cash to shareholders via healthy dividends or share buy-backs and valuations are attractive. Current uncertainties make it difficult to predict when this value will be unlocked, but we are confident that equities offer the best medium-term return potential.

Government bonds appear expensive to us, given negative real yields and high levels of debt faced by many issuers, and we see little scope for healthy total returns over the medium term. We are underweight bonds in aggregate, although we do see good value among corporate, high yield and emerging market debt. Here, excess yields provide ample compensation for the modest additional risks.

Where tight supply / demand metrics are supportive, we are relatively bullish on commodities. The property market offers a healthy yield pick-up over government bonds, and while some areas of the market are likely to suffer headwinds in 2012, the yield should be well underpinned. Finally, we remain underweight cash. With interest rates likely to remain low, better opportunities exist in risk assets.



Mark Burgess
Chief Investment Officer

Thought leadership

Global debt – All at sea

Executive summary

This paper addresses the global debt dynamics set to define the next decade for economies and markets. It evaluates, in particular:

- The different circumstances of developed world economies, with a focus on how these economies ended up in such dire straits
- How financial markets must adapt to the new world of debt, with a focus on the implications for markets of different policy approaches to unsustainable debt
- The outlook for those nations at the heart of the debt dilemma is assessed: the US, Japan, Greece, Italy and Spain, as well as the UK.

Debt is everywhere. Leverage has exploded across most major economies in recent decades – in many cases exponentially. Predictions of gloom have resurfaced continually, but economies have more often than not surprised with their ability to overcome the odds and stretch the cycle one more time. Large, developed economies have proven to be surprisingly resilient and flexible. However, the ‘Great Recession’ of 2008-2009 appears to have raised the bar to an unprecedented height. What happens when economies finally reach the limits of leverage?



Escaping the debt trap

The table below highlights some of the many options for escaping the debt trap. Understanding these options will provide the blueprint for implementing appropriate measures in the years to come. While the best strategy is growth, this table assumes that the traditional methods of boosting growth have been exhausted, which is indeed the case in much of the developed world today.

Markets will be shaped by the policy approaches to unsustainable debt trajectories

Policy response options	Overall effect of policy response	Possible impact on sovereign bond prices	Possible impact on risky* asset prices
Austerity programmes	May work, but unproven in economies with highly leveraged private and financial sectors	Higher	Lower
Borrow more to boost growth	Does not work in the medium to long-term, but can appear to work in the short term via stimulus	Lower	Higher in early stages, but lower as more prudence is required
Default / restructure debt	Does not work, but might be the only option for some	Lower	Lower
Reneg on promises to local constituencies (pensions, social support programmes)	Yes, likely to work but perhaps at the expense of political upheaval	Higher	Higher
Re-finance debt through higher savings	Likely to work but at the expense of slower growth	Higher	Lower
Print money and devalue currency	Yes it works, provided inflation is kept under control	Uncertain	Higher (in local currency)
Inflate your way out of the problem	No, does not work, unless one can continuously surprise the markets	Lower	Lower

Source: Threadneedle Investments, 2011.

Note: *Risky assets include equities, corporate bonds, emerging market bonds and high yield bonds.

Many countries will rely primarily on one or two of these approaches. Others will utilise multiple strategies, picking and choosing based on what is politically acceptable and what the markets will bear. The difficulty for markets is that some of these outcomes are good for risky assets, yet others can have a profound negative impact. The simple notion that ‘high debt is bad for economies and markets’ is misguided.

Thought leadership

The changing dynamics of emerging markets

Executive summary

This paper assesses the changing dynamics of the global economy, with a special focus on the outlook for emerging markets (EMs). It highlights, in particular:

- Emerging economies are leading global growth
- The global debt scenario is part of a two-speed world
- The resilience of EMs is not undermined by recent market volatility
- The EM investment scenario is changing significantly.

The rise of EMs, along with the deterioration of some developed market economies, is not a short-lived curiosity. Many developed nations, following years of growing financial imprudence and higher leverage, are bankrupt. The healing process will be long and arduous, and have a lasting impact on markets.

We have seen evidence of the shifts in the world economy that have profoundly altered the global investment landscape. These changes represent in particular a real globalisation of fixed income markets with a rupture of traditional asset classes, which challenge conventional investor thinking.

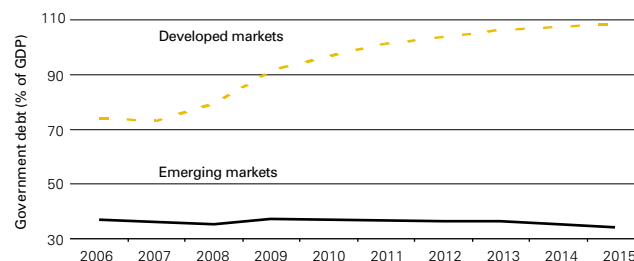


A two-speed world

The better debt position of most EM economies reflects the comparative ease with which they have been able to weather the global crisis. Balance sheets have been strengthened, whilst EM central banks have built record-high reserve cushions, leaving those countries better able to defend against any crises that may threaten their economies.

Debt challenges facing developed economies are therefore largely absent from the EM world. Following many years of sound fiscal policies, government debt levels remain at very manageable levels. Government debt / GDP is on average close to 35% for the 30+ countries that constitute the EM debt universe.

Emerging market debt is low and sustainable

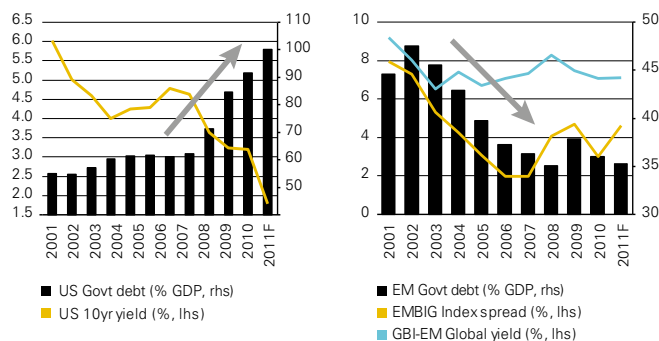


Source: Threadneedle Investments, Haver Analytics, May 2011.

Opportunities in emerging markets

The fiscal improvements of EM countries, maintained over the last decade, would not yet seem to be reflected in either spreads of US dollar debt or yields of locally denominated instruments. This mispricing is part of the wider phenomenon of a breakdown in distinctions between asset classes, where securities valued as being more risky by the market are classified as investment grade, while EM corporates may face low costs of credit protection and developed market corporates must pay more for credit protection.

Current valuations present investment opportunities in emerging markets



Source: IMF, JPMorgan, Threadneedle Investments, October 2011.

Latest Threadneedle news

Business update

We completed the transfer of assets from Liverpool Victoria (LV=) to Threadneedle on 1 November 2011, boosting our assets under management by approximately £8 billion. This new partnership with LV= reflects the strength of our investment team, our process and sustained long-term track record of excellent performance across a range of asset classes.

The Threadneedle (Lux) European Absolute Alpha Fund launched in January 2012 is our latest offering within the regulated absolute return space. Reinforcing our established absolute return range, this UCITS fund provides clients with access to a high conviction portfolio of long / short investments across a broad spectrum of European equities.

We added another strategy managed by our sister company Columbia Management to our Luxembourg SICAV fund platform in October 2011. The Threadneedle (Lux) US Contrarian Fund aims to identify and invest in undervalued large cap US equities.

We are in the process of opening an office in Stockholm to enhance our service to existing institutional clients in Sweden, as well as meet growing demand for a range of our investment strategies from across the Nordic region. This complements our existing presence in Copenhagen and illustrates our commitment to continued international development.

Team update

Toby Nangle joined in January 2012 as head of our Multi-Asset business. He will focus on developing further our £26 billion Multi-Asset franchise and proven track record in this area. Toby joins from Baring Asset Management where he was a director of both the Multi-Asset and Fixed Income teams.

We have appointed Iain Richards as Head of Governance and Responsible Investment. He will be responsible for the environmental, social and governance (ESG) research, policy and engagement on behalf of our investment team. Iain joins us on 20 February 2012 from Aviva Investors where he was Regional Head of Corporate Governance.

Neil Robson joined our Global Equity team in November 2011 as a senior portfolio manager to focus on concentrated global equity strategies. He brings over 20 years' experience in global equities, latterly with Martin Currie where he was a global portfolio manager.

Blake Hutchins joined our UK equity team as a portfolio manager in December 2011. Blake joins from Aviva Investors where he had responsibility for UK equity mandates.

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